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No. 03-932

In the Supreme Court of the United States

DURA PHARMACEUTICALS, INC., ET AL.,

Petitioners,

v.

MICHAEL BROUDO, ET AL.,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR MERRILL LYNCH & CO., INC. AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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QUESTION PRESENTED

Whether a securities fraud plaintiff invoking the fraud-on-the-market theory must demonstrate loss causation by pleading and proving in a reliable and non-speculative manner that the defendant's fraud actually caused the plaintiff injury.

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INTEREST OF THE AMICUS CURIAE

Merrill Lynch & Co., Inc. ("Merrill Lynch") is a diversified financial services company with 48,000 employees worldwide.[1] Merrill Lynch provides corporations, financial institutions, and governments with investment banking and advisory services, including underwriting new securities offerings. It also provides wealth management services, including retail brokerage, to more than a million clients. Merrill Lynch furnishes research and analysis concerning individual securities, prepared both by employee analysts and by third parties.

Like other financial services companies, Merrill Lynch is subject to federal class action suits brought by investors whose investments have not performed as they had hoped. Such suits, which mushroomed prior to passage of the Private Securities Litigation Reform Act in 1995, dipped temporarily thereafter. In 2000, however, a huge stock market "bubble" burst, causing trillions of dollars in market losses within a matter of months. The events that precipitated the collapse of the bubble also bankrupted or slashed the value of many issuers of securities, particularly internet and technology companies, diminishing prospects for recovering damages from them. Investors therefore turned their sights on the securities industry. They filed hundreds of class action securities fraud suits against firms that served as underwriters for issuers' stock offerings and that employed research analysts who offered opinions on the securities. Plaintiffs magnified the threat these suits posed by seeking certification of long class periods and

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[1] Pursuant to Rule 37.6, Merrill Lynch states that no counsel for a party authored this brief in whole or in part and that no person or entity other than Merrill Lynch made a monetary contribution to its preparation. The consents of the parties to the submission of this brief have been filed with the Clerk.

classes encompassing anyone anywhere in the world who purchased the stock.

Merrill Lynch is a defendant in a number of these suits. It is vitally interested in the question presented in this case, which affects how easily Section 10(b) suits can survive motions to dismiss or be certified as class actions and what must be proved at trial to establish liability. A permissive loss causation standard like that adopted by the Ninth Circuit threatens to make issuers and their advisers, and even the analysts who opine on a company's prospects, insurers against market fluctuations attributable to other events, including seismic shifts across broad markets like the bursting of the 1998-2000 stock market bubble. In an area where the threat of huge liabilities exerts so powerful a pressure to settle that few cases ever reach trial it is particularly important that the loss causation standard be rigorous enough to weed out meritless suits at the early stages of litigation.

Merrill Lynch believes that its experience with post-bubble suits and as a leading financial services company gives it a perspective that will be useful to the Court in considering the meaning of the loss causation requirement.

SUMMARY OF ARGUMENT

The Ninth Circuit's lax causation standard invites the abusive litigation and coerced windfall settlements that Congress in the Private Securities Litigation Reform Act sought to forestall. Weak causation rules arbitrarily reward speculators instead of compensating those truly injured by fraud, harm investors by increasing costs, create perverse disclosure incentives, and undermine the efficient operation of capital markets. To effectuate the goals of the Securities Exchange Act and PSLRA, this Court should insist on a more rigorous standard that screens out

speculative theories of causation and requires a plaintiff to show that defendant's misconduct actually and directly caused plaintiff's loss. In this case, that would require that plaintiffs plead and prove not only that Dura's allegedly misleading statements inflated the price of Dura's stock, but also that revelation of the truth resulted in a decline in price that can reliably be traced to the misstatement to the exclusion of other factors.

That standard serves the goals of the securities laws. It enables investors to obtain compensation for injuries caused by fraud, allows innocent defendants to dispose of meritless suits prior to trial and resist unwarranted class certification, and removes a serious impediment to the free flow of information in securities markets.

The hundreds of Section 10(b) class actions filed since the stock market bubble burst in 2000 demonstrate the need for this Court to adopt a rigorous loss causation standard. These suits seek to hold issuers, underwriters, and research analysts responsible for losses that investors incurred on risky stocks of unproven internet and high technology companies, which reached unprecedented highs on a wave of investor enthusiasm before losing most of their value within a few months. The Exchange Act and PSLRA require plaintiffs in these actions to trace their losses back to fraud by defendants and exclude both the effect of other forces driving the inflation and bursting of the bubble and company-specific factors that caused many investments to fail. Absent a rigorous loss causation standard, these class action suits threaten to seriously burden the federal district courts while chilling speech on subjects of importance to public investors.

The existence of numerous other civil, criminal, administrative and arbitral remedies, as well as practical incentives to truthful disclosure, ensure that a rigorous

causation standard will not detract from the deterrent and compensatory goals of the securities laws. The Solicitor General and SEC properly recognize that the Ninth Circuit's lax causation standard is not an appropriate means to supplement government enforcement.

ARGUMENT

I. PLAINTIFFS IN PRIVATE SECTION 10(b) DAMAGES SUITS MUST PLEAD AND PROVE IN A NON-SPECULATIVE MANNER THAT DEFENDANT'S FRAUD CAUSED PLAINTIFFS' INJURIES.

During an "'ebullient' stage" in the development of implied causes of action, this Court found an implied cause of action under Section 10(b) even though there is no indication Congress "considered the question of private civil remedies" when it enacted this antifraud provision. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 729-730 (1975); LOSS & SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1025 (3d ed. 1995). To prevent that judicially implied right of action from resulting in "'liability in an indeterminate amount for an indeterminate time to an indeterminate class'" (*Blue Chip Stamps*, 421 U.S. at 748, quoting *Ultramares Corp.* v. *Touche*, 255 N.Y. 170, 174 (1931)), this Court has repeatedly "narrow[ed] Rule 10b-5 as a matter of substantive coverage." LOSS & SELIGMAN, *supra*, at 1036, 1050.

As the Court explained in *Blue Chip Stamps*, it has pruned this "judicial oak" grown from a "legislative acorn" "as a matter of policy." 421 U.S. at 735, 737-739. It has rejected "expansive imposition of civil liability" under Section 10(b) because the implied cause of action "presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."

Id. at 739-740. In particular, the Court has recognized that, because of the risk of a jury verdict holding defendant liable for huge market losses, "even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success" if the plaintiff is able to "prevent the suit from being resolved against him by dismissal or summary judgment." And the threat of costly and disruptive discovery adds a further "*in terrorem* increment" to the settlement value of a suit. *Id.* at 740-741.

This Court has therefore repeatedly limited the scope of private securities damages actions to curtail their coercive potential and make meritless claims easier "'to dispose of before trial.'" *Blue Chip Stamps*, 421 U.S. at 742-743. See *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) (requiring proof of scienter, not mere negligence); *TSC Indus.* v. *Northway, Inc.*, 426 U.S. 438 (1976) (rejecting lax definition of materiality); *Santa Fe Indus.* v. *Green*, 430 U.S. 462 (1977) (limiting Section 10(b) to manipulative or deceptive conduct); *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1 (1985) (confining Section 14(e) to manipulative acts that involve misrepresentation or nondisclosure); *Central Bank* v. *First Interstate Bank*, 511 U.S. 164, 189 (1994) (rejecting aiding and abetting claims under Section 10(b) because they would engender "uncertainty and excessive litigation").

Despite these and other judicially imposed limitations, empirical studies showed that "[f]or practical purposes, the merits do not matter" in Section 10(b) class actions. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 501 (1991) (Section 10(b) became "a grotesquely inefficient form of insurance against large stock market losses" that "encourages the filing of more and weaker suits"). Bet-the-

company damages claims and huge litigation costs forced defendants into settlements that were neither "voluntary," because the risks mean that trial was not "a practically available alternative," nor "accurate," because "the strength of the case on the merits has little or nothing to do with determining the amount of the settlement." *Id.* at 499; accord Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J. L. ECON. & ORG. 55 (1991).

Responding to "significant evidence of abuse" that undermined "American capital markets" and caused "serious injuries to innocent parties" who were "forced to pay exorbitant 'settlements,'" Congress passed the Private Securities Litigation Reform Act ("PSLRA") "to protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation." H.R. Conf. Rep. No. 104-369, at 31-32 (1995) ("H.R. Conf. Rep."). The PSLRA prescribes an express "loss causation" standard, stays costly discovery pending ruling on motions to dismiss, establishes a safe harbor for forward-looking statements, and imposes other procedural and substantive limits to curtail abusive Section 10(b) class suits.

Nevertheless, respondents urge and the Ninth Circuit adopted a causation standard that moves headlong in the opposite direction, significantly easing plaintiffs' burden and encouraging abusive strike suits. Both Congress in the PSLRA and this Court have identified such lax causation rules as a particular concern and have insisted that plaintiffs show in a non-speculative manner that defendant's misconduct actually caused plaintiffs' losses.

A. Section 10(b) Claimants May Not Rely On Speculative Theories Of Causation But Must Plead And Prove That Defendant's Misconduct Actually Caused Them Injury.

Congress in the Exchange Act established the general principle that an investor may not recover an "amount in excess of his *actual* damages *on account of*" a violation of the securities laws. 15 U.S.C. § 78bb(a) (emphasis added). After years of experience with abusive Section 10(b) damages actions based on speculative causation theories, Congress expressly provided in the PSLRA that a private Section 10(b) "plaintiff shall have the burden of proving that the act or omission of the defendant * * * *caused* the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4) (emphasis added). The language of these provisions on its face requires a plaintiff "to plead and then to prove," without speculation, that defendant's act or omission caused a loss to plaintiff. H.R. Conf. Rep. at 41. This standard is not satisfied by mere allegation or evidence that defendant's conduct inflated the price of a security when plaintiff purchased it, for such inflation may or may not eventually result in actual injury directly traceable to defendant's illegal act or omission.

In adopting the PSLRA Congress recognized that Section 10(b) class actions are filed and settlements coerced whenever "a company's stock moves significantly, up or down." H.R. Rep. No. 104-50, at 16 (1995) ("H.R. Rep."). Such movements occur for many reasons. They do not by themselves show that a plaintiff's loss is due to defendant's misconduct. Accordingly, Congress sought to ensure "that plaintiffs prove that the loss in the value of their stock was caused by the Section 10(b) violation and not by other factors." S. Rep. No. 104-98, at 7 (1995) ("S. Rep."); see *Hearings before the Subcmte. on Securities of*

the Cmte. on Banking, Housing and Urban Affairs, S. Hrg. No. 103-431, at 568 (1993) ("market loss" difference between "purchase price" and "sale price" of stock does not identify "losses caused by fraud") (testimony of Patricia Reilly). Simply proving inflation at the time of plaintiff's purchase does not establish that defendant's wrongful conduct resulted in plaintiff's loss.

Congress's refusal to allow damages actions to proceed on the basis of speculative and indeterminate damages theories reflects principles previously announced by this Court. A series of decisions insisted on rules that avoid "throw[ing] open to the trier of fact * * * hazy issues of historical fact" about causation, and that "permi[t] exclusion prior to trial" of a Section 10(b) plaintiff who cannot prove "in a readily demonstrable manner" that an alleged fraud "damaged him." *Blue Chip Stamps*, 421 U.S. at 742-743, 746. See also *id.* at 734-735 (limiting Section 10(b) action to purchasers and sellers of securities because causation of injury to others would be "conjectural and speculative"); *Virginia Bankshares* v. *Sandberg*, 501 U.S. 1083, 1105-1106 (1991) (refusing to extend Section 14(a) private damages action to shareholders whose proxy was unnecessary to approval of a transaction to avoid "speculative claims" in which "[c]ausation would turn on inferences" that would be "hazy" and "unreliable"); *Dirks* v. *SEC*, 463 U.S. 646, 667 n.27 (1983) (declining to give weight to claims of "shareholder 'losses,' 'injury,' and 'damages'" where there was "no clear causal connection between inside trading and outsiders' losses"); *Santa Fe*, 430 U.S. at 474 n.14 (non-disclosure not actionable where plaintiffs "do not indicate how they might have acted differently had they had prior notice of the merger"). These precedents preclude recovery of losses that are "indirec[t]," "too remote," or speculative. *Holmes* v. *SIPC*, 503 U.S. 258, 268-269 (1992).

Consistent with these precedents, courts of appeals typically require proof that a defendant's misconduct determined the security's ultimate performance ("loss causation")—not merely that it induced plaintiff's purchase or sale of the security ("transaction causation"). *E.g.*, *Emergent Capital Inv. Mgmt.* v. *Stonepath Group*, 343 F.3d 189, 198 (2d Cir. 2003) (allegation that defendant's misconduct inflated the price of a stock is "a paraphrased allegation of transaction causation," which "may explain why plaintiff purchased" the stock but not "why it lost money on the purchase"); *First Nationwide Bank* v. *Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir. 1994) (properly dismissed complaint did not allege that misstatements were "the reason the transaction turned out to be a losing one"); *Robbins* v. *Koger Properties, Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997).

Without these limitations, Section 10(b) would be an uncompensated insurance mechanism covering losses attributable to events other than defendant's fraud. See *Bastian* v. *Petren Resources Corp.*, 892 F.2d 680, 685 (7th Cir. 1990) (Posner, J.) ("Defrauders are a bad lot and should be punished, but Rule 10b-5 does not make them insurers against national economic calamities" or "industry-wide phenomena"). Speculators in a risky market could effectively transfer the risk of bad investments to issuers and market professionals, even though, if those losses would have occurred regardless of any fraud, "any award of damages to them would be a windfall." *Id.* at 684-685.

"No social purpose would be served by encouraging everyone who suffers an investment loss because of an unanticipated change in market conditions to pick through offering memoranda," press releases, and analyst reports "in the hope of uncovering a misrepresentation." *Id.* at

685. Section 10(b) plaintiffs must plead and prove that the value of their securities fell "because of the misrepresented financial condition," not "as a result of some subsequent event." *Citibank* v. *K-H Corp.*, 968 F.2d 1489, 1496 (2d Cir. 1992). See *Moore* v. *PaineWebber*, 189 F.3d 165, 172 (2d Cir. 1999) (no liability for losses attributable to "intervening" or "extraneous" causes); *id.* at 177 (Calabresi, J., concurring) (purchase "as a result of fraud does not suffice to show loss causation when the whole market collapses"); *First Nationwide*, 27 F.3d at 769-770 ("when factors other than the defendant's fraud are an intervening direct cause of a plaintiff's injury, that same injury cannot be said to have occurred by reason of the defendant's actions"); *Bastian*, 892 F.2d at 684 (securities lost value because of market collapse, not risks concealed by defendant); H.R. Conf. Rep. at 42 (Section 10(b) damages limited to "losses caused by the fraud and not by other market factors").

In a case like this one, in which Dura is alleged to have made misleading statements concerning its business, these principles require that the plaintiff allege and prove a distinct inflation in stock price caused by defendant's conduct, and then a distinct deflation in price upon revelation of the truth that is directly linked to the defendant's false statements and is not explained by other events. Plaintiffs concededly have not so pled. In a manipulation case, the same principles require the plaintiff to show distinct inflation in a security's price caused by market manipulation, followed by a decline when the manipulation ceased that can be directly traced to cessation of defendant's misconduct rather than some other event. A less objective causation standard would be too easy to circumvent, thereby subverting Congress's goal of disposing of meritless Section 10(b) cases at the dismissal stage. S. Rep. at 7.

Any lesser showing would prove not that defendant's wrong caused plaintiff's loss, only that it might have done so. In particular, the "foreseeability" test used by some courts to address issues of proximate cause is poorly adapted to transactions in modern securities markets in which "[s]o many forces operate in the market for an active security that there is little certainty in identifying causes or measuring their separate effects." 4 BROMBERG & LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD § 7:498, at 7-985 to 7-986 (2d ed. 2004); see also 9 LOSS & SELIGMAN, SECURITIES REGULATION 4280-4281 (rev. 3d ed. 2004) ("With all the factors that determine stock market prices," any "lingering effects" of a fraud soon "become intermingled with many other market determinants").

A requirement that a Section 10(b) damages plaintiff allege and prove merely that its loss was "foreseeable"—rather than that it was directly caused by defendant's conduct—would encourage suits based on uncabined speculation, make impossible the early disposal of meritless suits, and give rise to the very abuses identified in *Blue Chip Stamps* and by Congress in adopting the PSLRA. See *Fogarazzo* v. *Lehman Bros.*, 2004 WL 1151542, at *11, *14 (S.D.N.Y. 2004) (refusing to dismiss Section 10(b) claim that analyst reports caused plaintiffs' losses after bubble burst on ground that it was "foreseeable" that market would ignore publicly known facts about issuer's dire financial condition because analysts were "optimistic"). Mere speculation that defendants may have caused investment losses is not enough to warrant giving plaintiffs the tools to extract massive settlements that, we show in the next section, undermine the investor-protective goals of federal securities legislation.

B. Permitting Section 10(b) Class Actions To Proceed On The Basis Of Speculative Theories Of Causation Would Do "More Harm Than Good."

"'[C]ourts must look to the underlying policies or legislative intent in order to draw a manageable line between those causal changes that may make an actor responsible for an effect and those that do not.'" *Dep't of Transp.* v. *Public Citizen*, 124 S. Ct. 2204, 2215 (2004); see *Blue Chip Stamps*, 421 U.S. at 735. Given Congress's aim in the PSLRA to enable "defrauded investors [to] recover their losses," while simultaneously preventing "abusive and meritless suits" that result in "serious injuries to innocent parties," "the investing public and the entire U.S. economy," the proper causation rule should require plaintiff to trace a measurable loss to defendant's wrongful conduct and allow defendants to obtain dismissal of claims that rest on speculative theories that cannot reliably support that showing. H.R. Conf. Rep. at 31.

Permissive causation rules requiring merely a causal link to price inflation but not to a plaintiff's loss would turn Section 10(b) into an uncompensated insurance scheme for speculators in high-risk stocks (and a rich harvest of fees for their lawyers), and would do "'more harm than good.'" *Hochfelder*, 425 U.S. at 214 n.33, quoting *Blue Chip Stamps*, 421 U.S. at 747-748. Because such rules result in compensation for market losses that are not reliably tied back to a defendant's misleading statement, they do not serve Congress's goal of compensating an investor for no more than his "actual damages" "caused" by the wrong.

Every delayed announcement of accurate firm information produces both winners (who sold during the period of inflation) and losers (who bought then and sold

after disclosure of the truth). POSNER, ECONOMIC ANALYSIS OF LAW 489 (5th ed. 1998). "Over the long run, any reasonably diversified investor will be a buyer half the time and a seller half the time" and will not benefit from "a legal rule that forces his winning self to compensate his losing self over and over." EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 340 (1991); see Winter, *On 'Protecting the Ordinary Investor'*, 63 WASH. L. REV. 881, 884 (1988) (describing ways in which diversification reduces risks to ordinary investors).

This balance of benefits and harms was pronounced during the bubble, when a high proportion of those buying and selling technology stocks were short term day-traders interested solely in movement in a stock's price over a few minutes or hours and not in the accuracy of information about a company or the integrity of its stock price as a reflection of the company's value. See SEC, DAY TRADING: YOUR DOLLARS AT RISK (Mar. 2, 2001); SEC, SPECIAL STUDY: REPORT OF EXAMINATIONS OF DAY-TRADING BROKER-DEALERS (Feb. 25, 2000); PERKINS & PERKINS, THE INTERNET BUBBLE 25 (1999). Momentum traders, though they might hold a stock longer than day-traders, similarly sought to take advantage of fluctuating price movements, aiming to sell before upward momentum ran out. See DEVITTO, IRRATIONAL MARKETS AND THE ILLUSION OF PROSPERITY 108 (2001) ("Momentum" investors "simply identify stocks with the greatest upward momentum and buy them"; "value or worth of a company is not a consideration"). These speculators traded the stock of a single company many times. Sometimes they benefited from delays in the dissemination of truthful information; sometimes they lost. Obviously, it would be unavailing to try to demonstrate loss causation simply by pointing to "price inflation" at the time such traders purchased stock.

The arbitrary provision of compensation to some investors for market losses that may or may not have been caused by defendant's conduct results in the very problem of abusive litigation and coerced settlements that Congress identified in the PSLRA. See, *e.g.*, Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 949-950 (1993) (stock transactions result in "litigation whenever investors have lost an amount sufficient to support an award of attorney's fees"; in one industry, a class action was filed to challenge *every* IPO where the stock traded below the IPO price after 15 months). This may be beneficial for lawyers and expert witnesses, but it is manifestly injurious to investors.

These suits "extract a deadweight loss from investors." *Id.* at 952. Continuing stockholders are harmed when the issuer incurs litigation costs and pays a massive settlement compensating some shareholders and their lawyers. See H.R. Conf. Rep. at 32 ("Investors always are the ultimate losers when extortionate 'settlements' are extracted from issuers"); S. Rep. at 9 ("long-term investors ultimately end up paying the costs associated with the lawsuits"); FRIENDLY, FEDERAL JURISDICTION 120 (1973). They are harmed too when investment banks and other professionals that are essential to raising capital and the efficient working of the market are subjected to open-ended Section 10(b) damages suits. Defending those suits drives up the cost of professional services and makes professionals unwilling to serve newer and smaller companies. *Central Bank*, 511 U.S. at 189, citing Winter, *supra*; see H.R. Rep. at 20 ("Fear of litigation keeps companies out of the capital markets," and "businesses suffer as auditors and directors decline engagements and board positions"); Alexander, *supra*, 43 STAN. L. REV. at 570-573.

Lax causation rules also disserve the core goal of the securities laws to ensure the free flow of information that is critical to investors and to market efficiency. H.R. Conf. Rep. at 42 ("Abusive litigation severely affects the willingness of corporate managers to disclose information to the marketplace"). A firm that discloses information "inevitably takes the risk of excessive optimism and excessive pessimism." EASTERBROOK & FISCHEL, *supra*, at 339. A "rule penalizing excesses in either direction would lead to silence" about a company's prospects. *Ibid.*

Investors particularly "want the issuer's own view of its future." KRIPKE, THE SEC AND CORPORATE DISCLOSURE 25 (1979). Broad causation theories bring the threat of massive liabilities for such prognostications (see *Asher* v. *Baxter Int'l*, 377 F.3d 727 (7th Cir. 2004)), creating a potent disincentive to discuss the company's future. See Backman, *Forward-Looking Statements and Cautionary Language After the 1995 Reform Act*, in PLI, SAILING IN "SAFE HARBORS" 153, 158-159, 208-209 (1997). Corporate managers' communications with analysts, which are "necessary to the preservation of a healthy market," are also muzzled by the risk of Section 10(b) suits based on weak causal links. *Dirks*, 463 U.S. at 658-659; see SEC, Release No. 33-7881, 65 Fed. Reg. 51716, 51718 n.19 (2000) ("fear of legal liability" "chill[s]" communications with analysts). When SEC disclosure requirements do not make silence an option, issuers may respond to the threat of unconstrained liability with defensive disclosure that "bur[ies] the shareholders in an avalanche of trivial information." *TSC*, 426 U.S. at 448; see *Basic Inc.* v. *Levinson*, 485 U.S. 224, 231 (1988).

Allowing Section 10(b) suits to proceed on the basis of speculative causation theories thus detracts from the quantity and quality of information received by investors.

Congress's goal in adopting more stringent limits on private damages actions in the PSLRA was to address the concern that Section 10(b) suits had "'chill[ed]" the "robustness and candor of disclosure.'" H.R. Conf. Rep. at 43; see H.R. Rep. at 19 ("abuse of the 10b-5 system * * * deters the voluntary disclosure of information that the Federal securities laws were designed to promote"); S. Rep. at 5. This Court has refused to interpret the Exchange Act in ways that undermine the free flow of information, and it should do so once again here. *Dirks*, 463 U.S. at 658-659.

Open-ended liabilities based on speculative causation theories also burden constitutionally protected speech. This Court should not expand implied private rights of action in a way that infringes on the First Amendment, especially with regard to expression in which there is such a strong public interest. See *Lowe* v. *SEC*, 472 U.S. 181, 210 & n.58 (1985) (there is "no doubt about the protected character" of "the expression of an opinion about a marketable security," "factual information about * * * market trends," and "commentary" on "market conditions"); *Nike, Inc.* v. *Kasky*, 539 U.S. 654, 664 (2003) (Stevens, J., concurring); *id.* at 676-678 (Breyer & O'Connor, JJ., dissenting). As the United States explained in its brief in *Nike*, the "First Amendment does not tolerate" a "private cause of action" for monetary relief against a company for "false statements respecting its products"—whether those statements "constitute 'commercial' or 'noncommercial'" or hybrid speech—because such "unconstrained" actions pose "a serious threat of unjustifiable chill to legitimate speech on matters of public interest" and to "the free flow of useful information." 2003 WL 899100, at *7-*8, *12, *20, *25. The United States pointed to the necessity of "constraining features" like rigorous standards of "actual" reliance and causation to

avoid an unconstitutional burden on speech. *Id.* at *20-*21, *23.

Furthermore, lax causation standards lead to "procedural intractibility" that imposes a considerable burden on the courts. *In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351, 366 n.28 (S.D.N.Y. 2003) (Pollack, J.). Dissatisfied investors "would be able (with the benefit of hindsight) to point to any allegedly misleading positive statement issued by anyone (not just the issuer) and couple that with an allegation that the price of the security was inflated as a result to satisfy loss causation," which invites "self-serving testimony, strike suits and protracted discovery." *Ibid.* Because the "issues would be hazy," the "litigation protracted," and the "resolution unreliable," these class actions would be especially burdensome. *Ibid.* (quoting *Grace* v. *Rosenstock*, 228 F.3d 40, 48 (2d Cir. 2000)); Alexander, *supra*, 43 STAN. L. REV. at 572 (describing "cost to the public in judicial resources").

Given all these considerations, it is important in devising rules governing Section 10(b) damages actions to "reconcile the conflicting interests of investors in a manner designed to best protect the interests of *all* investors—those who are plaintiffs in a particular case, those who are investors in the defendant company, and those who invest in other companies" whose access to capital markets and professional advice would be curtailed by excessive liability risks. S. Rep. at 22. The lax causation rule plaintiffs advocate would skew the securities laws in favor of Section 10(b) plaintiffs, who may or may not have been injured by defendant's wrongful conduct, at the expense of investors in general. It also would undermine the efficient operation of capital markets and create perverse incentives that contradict the securities laws' goal of ensuring robust communication concerning issuers of securities. Plaintiffs'

causation standard, in short, has nothing to recommend it. See *Central Bank*, 511 U.S. at 188 ("Extending the 10b-5 cause of action * * * makes the civil remedy more far reaching, but it does not follow that the objectives of the statute are better served").[2]

A standard requiring particularized pleading and a reliable showing that defendant's wrong actually and directly caused a plaintiff's loss suffers from none of these defects. It achieves what Congress intended by "reduc[ing] significantly the filing of meritless securities lawsuits without hindering the ability of victims of fraud to pursue legitimate claims." H.R. Conf. Rep. at 39.

C. Hundreds Of Post-Bubble Section 10(b) Damages Actions Illustrate The Need For Rigorous Loss Causation Standards That Weed Out Meritless Cases At The Dismissal Or Class Certification Stages.

The federal courts today are congested with cases that clearly illustrate the danger of lax causation standards and the need to uphold the more rigorous pleading and proof requirements that Congress mandated in the PSLRA. Investors have filed hundreds of Section 10(b) damages suits in the aftermath of the stock market bubble to recover losses incurred on speculative investments in unproven internet and technology companies. A record 503 private

[2] These problems are compounded by the willingness of lower courts to ease plaintiffs' burden of proof by expanding the *Basic* presumption of causation and reliance to situations ever more remote from the issuer misstatements addressed in that case. See pp. 19-21, *infra*; see generally Oldham, *Taking "Efficient Markets" Out of the Fraud-on-the-Market Doctrine After the Private Securities Litigation Reform Act*, 97 NW. U. L. REV. 995 (2003).

federal securities law class action suits were filed in 2001, the year after the bubble burst. NERA, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2003 EARLY UPDATE 2 (Feb. 2004). These class actions exert irresistible pressure to settle. Securities fraud settlements totaled $6.6 billion in 2001-2003. CORNERSTONE, POST-REFORM ACT SECURITIES LAWSUITS 1 (2004).

These suits reach beyond issuers of securities. Congress recognized in adopting the PSLRA that "[u]nderwriters" and "other professionals are prime targets of abusive securities lawsuits. The deeper the pocket, the greater the likelihood that a marginal party will be named as a defendant." S. Rep. at 9. When these "peripheral defendants are sued, the pressure to settle is overwhelming —regardless of the defendant's culpability." *Id.* at 21. Securities firms, which are perceived to have deep pockets and which inevitably are involved in some capacity in securities transactions, have been "prime targets" of post-bubble suits.

Plaintiffs, for example, have sued the underwriters of 309 bubble-era IPOs in class actions alleging that they misled investors about IPO allocation practices, principally alleged agreements that persons receiving IPO shares would purchase additional shares in the aftermarket. Those purchases supposedly inflated the price of the stock, in a gradually diminishing amount, throughout lengthy class periods that typically span the inflation and bursting of the bubble. *In re IPO Sec. Litig.*, No. 21 MC 92 (S.D.N.Y.). In addition, many suits have been filed against research analysts and their employers, alleging that analysts issued optimistic opinions they did not believe in order to protect their firms' investment banking work for the issuer, and that their opinions inflated the price of the stock during

some extended period. *E.g.*, *In re Merrill Lynch Research Reports Sec. Litig.*, No. 02 MDL 1484 (S.D.N.Y.).

The cost to settle such suits threatens to be enormous. One securities firm, which already has agreed to a multi-billion dollar settlement, has set aside reserves of nearly $10 billion to cover bubble-era securities fraud suits. Scannell & Pacelle, *Wall Street Gets Sticker Shock from Citigroup*, WALL ST. J., May 12, 2004, at C1. The *issuers* in the IPO suits, which are not plaintiffs' main target, have agreed to settle claims against them for $1 billion. Smith, *IPO Investors Get Assurance on Settlement*, WALL ST. J., June 27, 2003, at C1.

The causal assertions made in these cases are incredibly speculative and stretch beyond the breaking point the fraud-on-the-market theory adopted by a 4-2 plurality of this Court in *Basic*. Plaintiffs claim that a small number of open market "tie in" purchases of a security, made a few days after an IPO, inflated the price of the security and injured every purchaser throughout class periods of many months or years. They also contend that third party opinions, which are not alleged to have misstated facts about the issuer and which were circulated in a volatile market full of competing opinions, inflated the price of a security for long periods. But it is not a matter of "common sense and probability" to presume that limited aftermarket stock purchases or analyst opinions cause a lasting impact on stock price. No presumption of causation or reliance is justified in circumstances so far removed from those addressed in *Basic*. See *Hevesi* v. *Citigroup, Inc.*, 366 F.3d 70, 78-80 (2d Cir. 2004); *DeMarco* v. *Lehman Bros.*, 222 F.R.D. 243 (S.D.N.Y. 2004).

Congress understood that security prices "rise or fall for reasons unrelated to the alleged fraud" and insisted that plaintiffs may recover only for "losses caused by the fraud

and not by other market conditions." H.R. Conf. Rep. at 42. Plaintiffs may not simply "presume" that market prices were affected for lengthy periods but should have to disentangle any price effects of "tie in" purchases and analyst opinions from effects of other events. That task is "complex and uncertain" (*ibid.*), and not ordinarily possible in a class proceeding. Econometric tools for segregating the price effects of particular events are largely useless over long class periods. See *Elkind* v. *Liggett & Myers*, 635 F.2d 156, 171 (2d Cir. 1980) (it is "difficult if not impossible" to prove over more than a "short period" "the time when and extent to which the integrity of the market was affected" by alleged misconduct not involving issuer statements; "unrelated factors affecting the market price" make it "impossible as a practical matter to isolate" any "rise or decline in market price * * * caused by" that conduct); *Greenberg* v. *Crossroads Sys.*, 364 F.3d 657, 665 (5th Cir. 2004) (plaintiffs must show "stock's price was actually affected" by fraud, segregating effect of other factors, otherwise presumption of reliance and causation "would be based solely on speculation"); *Basic*, 485 U.S. at 253-255 (White & O'Connor, JJ., concurring in part and dissenting in part) (fraud-on-the-market approach is subject to limits of economic theory).[3]

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[3] See also Easterbrook & Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 627-628 (1985) (the longer the period examined the poorer "our ability to match particular pieces of news with the effects attributable to them"). Index comparisons cannot account for firm-specific factors. See *Akerman* v. *Oryx Communications*, 810 F.2d 336, 342-343 (2d Cir. 1987) (expert's "statistical analys[e]s" purporting to show that stock had gone down more than an index and had underperformed 82 of 100 new issues "lack[ed] credibility because they fail[ed] to reflect any of the countless variables that might affect the stock price performance of a single company").

The difficulty of disentangling effects of fraud and extraneous market factors over months or years is exacerbated in the tumultuous stock bubble market. See Langevoort, *Taming the Animal Spirits of the Stock Markets*, 97 NW. U.L. REV. 135, 177-178 (2002) ("noise and the presence of other information" render calculations of price effect of events "imprecise," "unusable," and "increasingly doubtful" as the time period under consideration lengthens); Dunbar & Heller, *Fraud on the Market Meets Behavioral Finance*, COLUM. L. SCH. CENTER FOR L. & ECON. STUD. (Dec. 1, 2003), http://www.law.columbia.edu/center_program/law_economics/wkshops/fall2003#81253.[4]

Determining whether plaintiffs have a viable loss causation claim cannot be deferred until trial. "If a defendant cannot win an early dismissal of the case, 'the economics of litigation may dictate a settlement even if the defendant is relatively confident that it would prevail at trial.'" S. Rep. at 7 (1995), quoting SEC Chairman Arthur Levitt. Accord *Blue Chip Stamps*, 421 U.S. at 740-741. The PSLRA's heightened pleading requirement and overt mandate that plaintiff must "plead" and then "prove" loss causation (H.R. Conf. Rep. at 41), along with the coercive

[4] Economists broadly agree that markets during the bubble were not "efficient," which is a necessary predicate for presuming under *Basic* that information is impounded in a security's market price. See *Gariety* v. *Grant Thornton*, 368 F.3d 356, 365-366 (4th Cir. 2004). The factors routinely used by courts to determine market efficiency—which focus on the existence of an active and developed market—are ill-adapted to assess whether the price of stocks trading in a bubble environment efficiently reflects economic value and are therefore apt to result in a finding of efficiency where economists agree there is none, and thus to an unwarrranted extension of *Basic*. See Dunbar & Heller, *supra*; *Cammer* v. *Bloom*, 711 F. Supp. 1264, 1286-1287 (D.N.J. 1989).

consequences of postponing consideration of loss causation, make dismissal an appropriate remedy to address defects in loss causation allegations.

The most powerful coercive effect of a Section 10(b) damages action derives from a willingness by the trial court to certify the suit as a class action. See *Blair* v. *Equifax Check Servs.*, 181 F.3d 832, 834 (7th Cir. 1999) ("Many corporate executives are unwilling to bet their company that they are in the right in big-stakes litigation, and a grant of class status can propel the stakes of a case into the stratosphere," giving plaintiffs and "even some district judges" a "device to wring settlements from defendants"). It is therefore incumbent on a court considering a motion to certify a class action to make an independent determination whether plaintiffs have met their burden of establishing that loss causation can reliably be proved across the entire proposed class using a fraud-on-the-market presumption or some trustworthy expert formula, or whether proof of causation must instead turn on time- or transaction-specific inquiries incompatible with class adjudication. *E.g.*, *Gariety*, 368 F.3d at 365-366; *West* v. *Prudential Sec.*, 282 F.3d 935, 938 (7th Cir. 2002); *Newton* v. *Merrill Lynch*, 259 F.3d 154, 166 (3d Cir. 2001); *Szabo* v. *Bridgeport Machs.*, 249 F.3d 672, 675 (7th Cir. 2001); see 2 HAZEN, THE LAW OF SECURITIES REGULATION § 12.12[3], at 539 (4th ed. 2002) ("the difficulty in discounting extrinsic market factors" in determining whether plaintiffs have been damaged "necessitate[s] complex analysis"; "the proof may vary from plaintiff to plaintiff and may thus require severing a class action").

Whether defendant's defenses to loss causation will require trade-by-trade or other time-specific inquiry is a key part of this inquiry. *E.g.*, *Amchem Prods., Inc.* v.

Windsor, 521 U.S. 591, 625 (1997); *Visa Check Antitrust Litig.*, 280 F.3d 124, 138 (2d Cir. 2001). The court "may not duck hard questions by observing that each side has some support" from experts. *West*, 282 F.3d at 938-940 (decertifying securities fraud class where "reputable financial economist" failed "to test for and exclude other potential sources of price movement"); *DeMarco*, 222 F.R.D. at 247-249 (refusing to certify class where plaintiffs' expert failed to demonstrate that analyst reports "materially impacted the market price [of the security] in a reasonably quantifiable respect" independent of the plethora of other information, opinion, and "confounding news" entering the market"); *Gariety*, 368 F.3d at 365-366. It would be far too easy an end run around the PSLRA to allow a plaintiff at the class certification stage to show that causation is an issue common to the class by offering speculative expert testimony. See *Reiter* v. *Sonotone Corp.*, 442 U.S. 330, 345 (1979) (courts must be "especially alert" to "administrative chaos" and "class-action harassment" at the class certification stage).

II. A RIGOROUS LOSS CAUSATION STANDARD THAT GUARDS AGAINST BLACKMAIL SETTLEMENTS AND WINDFALL RECOVERIES WILL NOT UNDERMINE THE DETERRENCE AND COMPENSATION POLICIES OF THE SECURITIES LAWS.

This Court need have no fear that requiring Section 10(b) plaintiffs to satisfy a rigorous, non-speculative loss causation standard, as Congress intended, will undermine the deterrence and compensation policies of the securities laws or hobble their enforcement. The SEC disagrees with plaintiffs that a diluted loss causation standard is necessary to effective operation of the securities laws, and for good reason. "[T]he deterrent effect is weak" when "the merits of claims" are "irrelevant to their initiation or settlement

values," as is the case with many Section 10(b) damages suits. Winter, *supra*, 42 DUKE L.J. at 952. Meritorious securities fraud suits, of course, will satisfy a rigorous causation standard. And a plethora of other judicial and administrative remedies targeted at truly wrongful conduct by expert regulators and prosecutors also ensure that a rigorous causation standard will not have adverse effects.

SEC regulations impose stringent reporting obligations on corporations, subject to SEC enforcement proceedings. Corporations must file quarterly and annual financial statements, which executives now must certify under threat of criminal penalty and disgorgement of their compensation and stock trading profits. 15 U.S.C. §§ 7241, 7243; 18 U.S.C. § 1349. Issuers also must file, within four business days, Form 8-K reports on any of a host of material corporate events, including agreements, acquisitions, disposition of assets, off-balance-sheet financial obligations, and changes in officers or directors. SEC, Release No. 33-8400, 69 Fed. Reg. 15594 (2004).

The powers of the SEC and Department of Justice to enforce corporate disclosure obligations are substantial and do not depend on proving loss causation. The Commission may obtain injunctive relief, cease-and-desist orders, orders barring or suspending individuals from serving as an officer or director of an issuer of securities, and large civil penalties, including disgorgement of any gain. 15 U.S.C. §§ 78u, 78u-3; see *SEC* v. *First Jersey Sec.*, 101 F.3d 1450 (2d Cir. 1996) (requiring disgorgement of $75 million). Under the Sarbanes-Oxley Act, the SEC may earmark penalties and amounts disgorged "for the benefit of the victims" of the violation. 15 U.S.C. § 7246(a).

A person who willfully and knowingly makes a false or misleading statement of material fact may also be criminally liable and is subject to imprisonment for 20

years and multi-million dollar fines. *Id.* § 78ff. The recent indictment of Enron CEO Kenneth Lay, for example, rests in part on statements he made about the company in an online employee forum and in calls with research analysts. See Coffee, *Overcriminalization?*, NAT'L L.J., Aug. 16, 2004, at 13. Insiders who trade with knowledge of material information that has not been disclosed to the public face civil penalties of three times the profit gained or loss avoided. 15 U.S.C. § 78u-1. The Securities Act authorizes many similar remedies for misstatements made in connection with the registration of securities, for which liability may be established without proof of scienter. *Id.* §§ 77t, 77y. Underwriters and broker-dealers are subject to equivalent deterrent and remedial sanctions, as well as a host of specialized standards applicable to their operations.

The SEC is not reluctant to use these powers. The goal of SEC enforcers has been described by former Chairman Richard Breeden as leaving securities law violators "naked, homeless, and without wheels." Eisenberg, *Enforcement Issues and Litigation*, 21 SEC. REG. L.J. 421, 421 (1994). In the aftermath of the bubble and recent corporate scandals the Commission's 900-strong enforcement staff has shown extraordinary vigor. During fiscal year 2003 alone the SEC brought 271 injunctive actions and 365 administrative proceedings against issuers and financial services providers—far more than the 216 private securities class actions filed in federal court in 2003 (see http://securities.stanford.edu)—and obtained orders requiring the disgorgement of $900 million and the payment of $1.1 billion in penalties. SEC 1993 Annual Report 15, http://www.sec.gov/pdf/annrep03/ar03enforce.pdf. Recently, the SEC and other regulators obtained a $1.4 billion settlement from ten securities firms accused of issuing research opinions tainted by conflicts of interest, and well over a billion dollars in settlements with mutual

fund companies accused of market-timing violations, specialist firms accused of "front running," and underwriters accused of IPO allocation violations.[5] The Department of Justice's Corporate Fraud Task Force has charged hundreds of defendants since it was formed in July 2001, including senior officers and managers of securities issuers and employees of financial services companies, obtaining many guilty pleas and convictions. http://www.usdoj.gov/dag/cftf.

State prosecutors and blue-sky officials bring their own overlapping civil and criminal enforcement actions. Among state securities law enforcers, for example, the New York Attorney General alone has reported substantially more than $1 billion in settlements with financial services companies already in 2004. http://www.oag.state.ny.us/press/agpress04.html.

Financial services industry Self Regulating Organizations ("SROs") actively enforce their regulations, which implement and supplement the securities laws. In 2003 the National Association of Securities Dealers ("NASD") barred 494 individuals from the securities business, suspended 333 others, and expelled 30 firms. http://www.nasdr.com/2380.asp. The New York Stock Exchange brought 231 cases of rules violations against members that

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[5] *E.g.*, http://www.sec.gov/news/press/2002-179.htm ($1.4 billion global settlement in analyst conflict of interest cases); *id.* at 2004-14.htm ($225 million settlement in case alleging market timing trading in mutual funds); *id.* at 2003-176.htm ($250 million market timing settlement); *id.* at 2004-42.htm ($240 million settlement in case against five specialist firms for executing orders for dealer accounts ahead of executable public customer orders); *id.* at 2002-14.txt ($100 million settlement for alleged practices relating to allocations of stock in IPOs).

year. http://www.nyse.com/regulation/p1020656068597.html?displayPage=%Fregulation%2F1022221394131.html.

Furthermore, agreements between broker-dealers and their customers invariably include arbitration provisions. NASD arbitration, which this Court has strongly endorsed as a means to resolve securities fraud claims, is thus readily available to investors. NASD MANUAL § 10101; see *Shearson/American Express* v. *McMahon*, 482 U.S. 220, 232 (1987) (describing the "suitability of arbitration as a means of enforcing Exchange Act rights" and "competence of arbitral tribunals to resolve § 10(b) claims"). Arbitration focuses directly on the central issues in dispute, such as whether a client has been directed to unsuitable investments or a broker made a material misstatement to the customer. Arbitration—in which legal representation and discovery are available and experienced decisionmakers consider the facts and circumstances of each case—is less costly and quicker than litigation and increases the share of recovery that an investor retains. See *Howsam* v. *Dean Witter*, 537 U.S. 79, 85 (2002) (NASD arbitrators' "comparative expertise" helps "to secure a fair and expeditious resolution of the underlying controversy"). Smaller claims are channeled into a simpler procedure for even faster and more economic resolution. NASD MANUAL §§ 10302, 10316, 10321-10322.

Since the stock market bubble burst, thousands of investors have discovered that arbitration provides a fair and efficient forum for resolution of claims against broker-dealers. Nearly 9000 arbitration cases were filed with NASD in 2003. Customers received awards in more than half of the 7300 NASD arbitration cases closed that year. See http://www.nasdadr.com/statistics.asp.

Securities market participants are thus hemmed in by an array of federal and state government powers, both civil

and criminal, SRO sanctions, and arbitral remedies, which effectively curb unlawful practices and compensate non-speculative injuries. As Judge Friendly observed, "[t]he important thing is to stop the evil conduct" and "an injunction," "fines," or other sanctions imposed at the behest of expert government and SRO regulators achieve that purpose without the risk attendant on civil damages actions of "ruin[ing] innocent stockholders," "produc[ing] blackmail settlements," or deterring desirable conduct. FRIENDLY, *supra*, at 120. Given the availability of these fact-specific remedies, which deter and punish misconduct and compensate those who truly are its victims, there is no reason why this Court should recognize, in a judicially implied cause of action, a class-wide liability that rests on speculative inferences of causation.

Indeed, even against the background of a far more rudimentary enforcement system than exists today, this Court refused in *Piper* v. *Chris-Craft Indus.*, 430 U.S. 1 (1977), to imply a cause of action for damages for violation of Section 14(e) of the Exchange Act—prohibiting fraud in connection with a tender offer—because the threat of damages was not necessary to deter fraudulent conduct. "[I]njunctive relief" is more effective than "a damages award" that also "may well be inconsistent with the interests of many members of the protected class." *Id.* at 42. Reversing a court of appeals' ruling that implied a damages cause of action and invoked a "presumption of reliance and causation" in the name of deterrence and "effective" remedies (*id.* at 17-18), this Court observed that "uncertainties" about whether particular conduct amounts to a legal violation and "caused injury" "call into question whether 'deterrence' of § 14(e) violations is a meaningful goal" except for "the most flagrant sort of violations which no reasonable person could consider lawful." *Id.* at 40 n.26. And for those

"obvious and serious" violations, "injunctive relief" is "apt to be the most efficacious form of remedy." *Ibid.*[6]

Congress has limited recovery to "actual damages on account of the act complained of" (15 U.S.C. § 78bb(a)) and required plaintiffs to plead and prove that the misrepresentation or omission "caused the loss for which the plaintiff seeks to recover." *Id.* § 78u-4(b)(4). Particularly in light of the alternative remedies and sanctions, "any extension of [the securities] laws, to approach something closer to [the] investor insurance scheme" that plaintiffs seek "should come from Congress, and not from the courts." *Basic*, 485 U.S. at 256-257 (White & O'Connor, JJ., concurring in part and dissenting in part).

CONCLUSION

The judgment of the Ninth Circuit should be reversed.

Respectfully submitted.

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[6] Quite apart from the panoply of available legal remedies, self-interest provides a powerful incentive to timely and truthful disclosure. "[T]he market provides strong incentives for anyone who desires continued access to the market to keep the signals honest." KRIPKE, *supra*, at 126; see *Piper*, 430 U.S. at 40 n.26.

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